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The Relationship between German Banks and Large German Firms

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Large German banks provide all kinds of financial services to large industrial companies and participate in an effective system of corporate governance. But contrary to widely-held views, they do not own German industry.

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This paper — a product of the Financial Policy and Systems Division, Country Economics Department — is part of a larger effort in the department to study the role and functions of financial institutions. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Wilai Pitayatonakarn, room N9-003, extension 37644 (May 1992, 32 pages).

German banks are often criticized, or praised, depending on a person's viewpoint, for owning German industry and for playing an active part in corporate control.

Harm argues that this misrepresents German banking. First, the number of German firms a bank can own or control, although significant, is limited.

Some very large firms are predominantly privately owned, or are not chartered as joint-stock companies that could potentially be listed on an exchange. Most small firms, and even some large firms, do not even have a supervisory board — which is the most important forum through which bankers can represent their interests in a firm.

Second, although most of the largest 100 firms have a bank member on their supervisory board, this does not imply effective bank control. Many companies have two bankers from different institutions on their board.

Third, the role of the banker in the supervisory board has to be viewed in the light of the rigorous standards of corporate governance imposed on German public firms. The Codetermination Law of 1976 mandates that labor be represented on the supervisory board of the largest firms as well as all joint-stock companies.

This stresses the role of the supervisory board as a negotiating forum for all interested parties. It leaves little room for the interpretation that the bankers are exclusively in control.

Fourth, bank ownership of industry is not pervasive, but is in fact limited to a few special cases. Ownership of significant stakes has further decreased during the last decade.

Fifth, proxy voting is more important than stock ownership as a potential means of control. Harm notes that it is generally agreed in Germany that banks provide a useful service to small shareholders. Although more than half of the largest 100 firms are not affected by proxy voting, the continued attractiveness of corporate equities for the general public suggests that the control issues associated with proxy voting will become increasingly important.

Harm argues that the German system of corporate governance represents an efficient attempt to minimize socially wasteful behavior. The negotiated consensus achieved in the boardroom provides better incentives to management to maximize firm value and social welfare than the factionalized U.S. system.

OUTLINE

1. Introduction

The task set out for this research is to give the reader a comprehensive overview of the institutional structure of the German banking system in its role to finance large German firms. To some extent, this paper is a response to a still prevailing myth in the Anglo-Saxon literature: that German banks own or control German industry.

The size structure and the structure with respect to legal incorporation have already been shown by Harm [18] to limit the scale and scope of ownership and control by German banks. The discussion of the governance bodies as defined by law will show that the extent of control that comes with a Board seat is more limited and different in nature than for example in the USA. We will see that the role of banks in corporate control - although partially rooted in history - is also due to the legal environment, but most importantly can carry economic efficiency properties due to the closeness of the concepts of monitoring and control.

Chapter two will be more analytical, showing the difficulty to exactly separate the two issues of monitoring as a pure information gathering activity, and control as decision-taking, with consulting activities bridging the two concepts. We intend to show that the two issues are difficult to separate, comparing the monitoring functions of banks to that of internal auditing departments, external auditors, and Boards of directors. The comparison of Board structures in Germany and the USA is to provide more insights as to why bankers would be more likely to hold Board mandates in Germany, but not in the United States.

Chapter three will discuss the relationship of the large German banks with large industry. Factual information, as far as publicly available, will be provided on the extent of bank ownership of large firms, the extent of the banks' use of proxy votes, and the extent of Board mandates held by bankers. This will be analyzed in the context of what had been said in chapter two about control associated with debt claims. The analysis will not be able to conclude that German banks abuse their power to the detriment of any other stakeholder in the firm, and it is not even clear whether the bank has strong incentives to do so.

2. The thin line between monitoring and control: from information gathering to decision-taking

The system of planned economies has presumably failed, because the centralized institutions cannot overcome the information problem. They have insufficient means of assessing the demand for existing products, or of deciding the direction of R&D investments to meet the demand for product innovation. If we have learnt anything from recent history, then it is that the decentralized planning system, where information is exchanged via the price system, is infinitely more efficient in meeting the demands of the economic units in a society. Yet, the banking system, when viewed as a unit, has a task not unlike that of a central planner. A bank that operates nationwide has to decide on the profitability of investments across virtually all industries. We would like to show here how the German banks handle the information problem.

2.1. Debt claims as satisficing instruments

Before we descend to the reality of information gathering, a few general remarks on the demand for information seem appropriate. Recently, the theory of transaction cost economics has also made its way into the theory of finance.[1] As regards the choice between debt and equity investments, transactions costs economics argues that debt claims are satisficing instruments in the sense of Herbert Simon's [41] concept of bounded rationality: they yield a satisfactory return to the investor, thereby also limiting his demand for information.

The choice between debt and equity investments is contingent on the information processing capabilities of the investor. The well informed investor will choose equity, and invest substantially in information gathering to participate in the decision-making process, while the uninformed investor chooses debt, as he has no means to process the information on the investment project efficiently enough to meaningfully influence (or take) management decisions.[2] Viewed in this light, it is no coincidence that the banking systems around the world, which all face the problems of information gathering in a centralized institution, invest their funds as debt claims - satisficing instruments - to limit the amount of information necessary for efficient investment decisions.[3] This is likely to be the single most important feature of a rather centralized system of investment institutions like a banking system. The following sections are meant to explain how German banks institutionalize meeting their demand for information on their clients and what their means of control are.

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[1]Williamson [45]

[2]See Hax [21] and Harm [20] for this interpretation of the evolution of the structure of financial claims.

[3]This was a core argument against the implementation of an Islamic banking system (Harm [19]).

2.2. Information from clients' accounts and balance sheet data

Processing accounting data of the client firms is the bread and butter of the banking business in every country, and the German banking system is not different in that respect. Accounting data are the typical means by which a centralistic institution tries to overcome the information processing problem referred to above. As it is impossible for a centralized agency to gather and process data on the individual decisions facing the decentralized units one tries to develop summary statistics that make the most different individual cases comparable. As every bank client has to submit a balance sheet, and displays a certain behavior towards the bank with the handling of lines of credit, these items are the natural sources of bank information.

Balance sheet data inherently have a more long-term information content than the handling of clients' accounts, as they ultimately provide meaningful information on a single client only in comparison across years. Balance sheet data can only provide information in long-term trends, while information from clients' accounts is more rudimentary, but also much more timely, and can trigger immediate action.

The accounting data available to the banks are pooled within the banks, and structured with respect to industry, size and legal form of incorporation. First, the information is processed in regional and national headquarters to provide the decision-makers there with summary statistics on the multitude of clients handled by the branches. Then, the pooled statistics flow back to the branches for the assessment of individual clients in a cross-section of related firms.

Recently, Meyer [31] has come up with a detailed study on the different modes of analyzing accounting data in various banks or groups of banks. His findings are especially interesting when we examine the roles of the different kinds of banks with respect to their market niches as described above. We have already stated,[4] how the legally independent Sparkassen and cooperative banks have created systems of internal capital markets to help each other. This is no different in the case of analyzing accounting data.

Savings banks and credit cooperatives have centralized their respective systems to process accounting data from the client firms so that each member bank processes its data on a particular client according to a standard format. The study by Meyer [31] also revealed that the savings banks take a leading role in the banking industry with their state of the art of data analysis, and that also the information processing system of the credit cooperatives is extremely refined compared to other banks. We want to offer three potential explanations for this phenomenon.

First and probably foremost stands the fact that small banks have few means to diversify. They are virtually by definition limited to a particular region, and are thus more vulnerable to regional shocks than large banks. As regions also have typical industries, this

[4]See Harm [18]

results also in an unhedgeable position with respect to industry. Furthermore, we have shown in Harm [18] that small banks are also more exposed to small firms. All these factors lead to a significantly larger bank specific risk stemming just from the fate of being small. This disadvantage compared to the larger banks can obviously lead to a larger demand for information to assess the individual risk, as it is covered to a lesser extent through portfolio diversification.

Secondly, the large banks also translate the pooled information of accounting data into exposure policies with respect to branches or other characteristics so that the use of the pooled data for cross-sectional comparison with an individual firm may not be viewed as important, and the data needed for exposure policies need not be as detailed as if they were used for credit analysis. The absence of systemic exposure guidelines in the case of the Sparkassen and cooperative banks coupled with the more client oriented information gathering mechanisms may actually turn out to be an advantage for the small banks.

No firm can unambigously be assigned to any one industry, and a limit on industry exposure can effectively hinder a branch of a large bank from making a loan to a creditworthy client - a typical example of resource misallocation due to the limits of information processing in a centralized institution. It is likely that the Sparkassen and cooperative banks make good on their diversification disadvantage by not being exposed to industry limits and instead spending more energy on gathering information on individual risks.

Viewing bank size and the structure of the different banking groups' clienteles as external variables, the above analysis suggests that large and small banks have structured the gathering and use of information optimally depending on their situation. Whether the size of the average client also determines the size of the lending bank is subject to speculation. Why should the branch manager of a small branch in a big bank be in a better or worse position to lend efficiently to small businesses? He might be at a disadvantage, if exposure limits lead to higher misallocations of resources in the case of lending to small firms as opposed to large firms, but that is still an unsettled issue.

One last reason, probably the most speculative, of explaining the observed differences in information gathering policy is that the smaller banks have a clientele of firms that are often owner-managed, with less potential influence of the banker on the owner-manager as in the case of an employed manager, who may be more prone to accept the banker's authority, especially if the banker is a member of his firm's Board.

2.3. Direct and indirect consulting activities

Accounting data have above been identified as the most basic pieces of information that a bank can base its financing decisions on. As a bank needs to economize on the costs of information acquisition and has to cover the entire spectrum of firms in the real sector, the general level of analysis cannot go beyond summary statistics. However, there are a number of instances, where the bank has to go beyond that level of analysis in order to assess the clients' creditworthiness. In these instances, the distinction between information acquisition and information provision (consulting) begins to blur.[5]

Unlike an equity investor, a bank is not interested in the impact of a manager's marginal decision on the firm's profitability, but it nevertheless is interested in the impact on the firm's probability of bankruptcy. The more likely bankruptcy becomes, the larger the incentives of a bank to influence management. This may happen when balance sheet data point at a negative trend, but in Harm [18] we also discussed the importance of consulting and advisory services above in the case of business start-ups, because the probability of failure is larger for new enterprises.

Consulting is a word used with varying definitions, and we use it here in the broadest sense. Any salesman of a product is typically more of an expert regarding his product than his client. In case he would not only sell the product, but also recommend the optimal use of it, he would in this sense perform a consulting activity, as he not only sells a product, but also information.

Bickel [4] discussed a long list of consulting activities of banks, and financial advisory services are naturally on top of the list, as they are directly related to the banks' product. Consulting is never only providing information, but it is necessarily preceded by acquiring information on the respective problem in order to yield an analysis that helps the management of the firm. Thus, when a bank should decide that a particular client demands more investigation for example in his financial planning, they may actually provide a consulting service to him after they find out about the state of financial planning in the respective firm.

Bickel [4] argued that such kinds of consulting services provided by banks are especially prominent in their relationships with small firms, because the bank has many services to offer particularly to small firms. Bank staff typically has a business oriented training, while the managers of small firms typically started their business or got to their position in the firm, because they were experts in their product's market.[6] This is also an experience that was mentioned by virtually every banker that was interviewed in the course of this project: the critical phase in any business is when it grows to a size that the manager becomes more and more involved in administration, representation, and planning, and gets more disattached from the product. In this situation, the bank can assist its clients, ultimately for its own good.

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[5]In this context, a quote by Alfred Herrhausen [22,p.103]: "The control institutions of the corporations became consulting institutions, because the important feature of a control institution is not to uncover mistakes made in the past, but to prevent mistakes from being made." (Free translation) This corresponds to the changing role of internal auditing departments as voiced by Puchta [40,p.65].

[6]Bickel [4,p.202]

Typically, the next important activity after financial advisory services (translating investment plans into financial plans) is the scrutiny of a firm's information system, as this is part of the bank's know-how. Another obvious area is the financial part of mergers and acquisitions. When the bank's own expertise reaches its limits, the usual step is to call in an auditing or consulting firm, always provided the management agrees to such measures.[7] The move of banks to have their own consulting firms is a very recent move in Germany, and has little to do with the historic performance of the German banking system, but I was also surprised to learn that one large bank had only two years ago insitutionalized meeting the demand for consulting and advisory services by creating a separate division only for that task.[8]

The answer lies in the traditional procedure to employ outside agents for the consulting and analyzing activity. Every banker interviewed was ready to admit that in the bank there was certainly no expertise on the individual product markets, and with all that has been said above, this cannot be efficient, as it would be analogous to a planned economy. Also today, product related topics are not part of bank consulting, but we meant to have shown in this section that more detailed analyses of client firms, triggered by signals from accounting data, often end up to be indistinguishable from consulting activities. Again, this feature is especially important in the lending activities of German banks to firms in the Mittelstand.

2.4. Banks' involvement in the Boards of client firms: a US - German comparison

While consulting and advisory activities are a control device of intermediate intensity, as they show features of both information acquisition as well as information provision to improve the quality of decisions, banks can also send members to the Boards of client firms with the result of greater possibilities to actively influence the decision-making process in the firm's management. This is the ever lively debate on the power of German banks.[9] We do not intend to diminish the potential power that German bankers hold in large firms through the companies' Supervisory Boards (Aufsichtsräte), but a number of qualifiers are necessary to assess the true dimension of the scope of influence by the banks.

The first qualifier to be inserted has already been provided in Harm [18]. It was shown there that the share of AG's in the domestic revenues accounted for approximately 21%. The AG is the only corporate form that is legally required to have an Aufsichtsrat

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[7]It should be clear that in a situation of financial distress, which triggered the bank's demand for more information in the first place, the bank has a lot of leverage to force such a measure on the manager of the firm.

[8]One employee there stressed the notion that it was a move by his bank away from collateral and towards creditworthiness lending. That this happened only two years ago shows something about the nature of the banking industry.

[9]See for example Greiffenberg [16], Herrhausen [22], Huffschmid [24], Der Spiegel [10,12], and Industriemagazin [26].

(Board of Directors). For the GmbH and the Personengesellschaften with less than 2000 employees, the formation of an institution to represent shareholder interests with respect to management is optional, and is called "Beirat". The Beirat is an informal institution, whose charter is defined in the company's statutes. Firms with more than 2000 emplyees have to have a Board for labour representation.

It is therefore important to differentiate between shareholder representation in the AG and other corporate forms, mostly GmbH's. Gaugler and Heimburger [14] conducted a survey which showed that bankers are not often present in the Beiräte of the firms in the Mittelstand so that our attention here is focussing on the Boards of the AG's and other large firms that are required to have a Board.

Moreover, it is very important to distinguish between the German Aufsichtsrat and the American Board of Directors. Although the two institution serve the same purpose, they nevertheless have significantly different structures. A comparison of the two structures has been provided by a detailed investigation by Bleicher, Leberl and Paul [5].[10] Probably the most important difference they pointed at is that German corporations are governed by two legally separate bodies, the Vorstand, which is responsible for the day-to-day management, and the Aufsichtsrat, which is responsible for the supervision of the Vorstand. In the US, there exists a distinction of inside and outside Board members, which are nevertheless part of the same body.

The important difference is that the authority of the Aufsichtsrat is limited, while the outside Board members have the same authority as the inside Board members. This leads to the effect that, however influential a German Board member may have been in pushing a decision, he is usually not legally liable for a managerial decision. An American outside Board member, however, is liable for management decisions to the extent that the "Duty of Care" principle can be applied against him.

That the German Aufsichtsrat is absolved from the consequences of actual management is an important consideration when examining the role of German bankers in their client firms' Boards. Prowse [37], in an empirical study on the impact of close relations between Japanese banks and their clients argued that the threat of "equitable subordination" was a major deterrent for banks in the US trying to assume a more active role in the managements of ailing clients. He was arguing that the absence of such a legal threat in Japan fostered Japanese banks' close relationships with their clients. We are making the same case here for Germany.

The separation of management and Board is most certainly due to a belief that a management should not be in a position to control itself, which has always been a concern in the American system, resulting in several changes[11] for more authority of outside members

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[10]After this quoted as BLP.

[11]BLP [5,p.128-139]

initiated by, for example, the SEC or the NYSE. Proposals with similar content have been made by the American Law Institute, and there was even a legislative attempt in the form of the corporate democracy act of 1980, which, however, was not successful.

Another argument in favor of the separation of the two institutions again has to do with the issue of information processing and decision-making at the top of large hierarchies. While management operates decision-making in its environment every working day, the Aufsichtsrat meets rather infrequently, yielding a natural information disadvantage for the Board members.

To put comparatively minor issues outside its reach of control is a protection of management against overly ambitious Board members to step over their limits of competence. This is also a feature that appears in management contracts of smaller corporations. They not only protect the owner from abuse by management, but also management from unnerving interference in day-to-day business by the owner. We would like to argue here that the combination of the necessarily limited information of an Aufsichtsrat member and the limits to his authority make the task of the Aufsichtsrat as defined in the Aktiengesetz more suitable to the experience of a banker.

Another important difference between the German and American system of corporate governance is the philosophy behind the motivation to create an institution of a Board in the first place. While in the US the function of the Board as a representative of shareholders dominates, the German Aufsichtsrat is a more general forum for various groups of stakeholders to influence management.

This philosophy is most apparent with the passing of the "Mitbestimmungsgesetz" in 1976, which gave labor representatives of the firm up to almost half of the seats in the Aufsichtsrat. Although this may have been triggered by the then common practice of bankers - also outside stakeholders in the firm - to be represented, it shows that the Aufsichtsrat is much more viewed as a democratic negotiating forum in Germany than in the United States. Much of the outrage of American practitioners at the idea of bankers being represented in their Boards is likely to come from their reality of an American Board of Directors. We would dare the hypothesis that bankers' representations on client firms' Boards would not have happened to the extent it did in Germany, if there was an American style corporate governance system.

At the end of this chapter, we would like to have conveyed the insight that the control mechanisms to be discussed hereafter are not per se alien to the tasks performed in a bank. A Board mandate is almost a logical extension of consulting services, and is to a significant extent used as such. From decision support to decision making is only a small step.

3. German banks and stock markets - features of a universal banking system

In Germany's universal banking system, banks are allowed to assume all functions that in the USA would only be associated with investment banks: underwriting of equity issues, stock brokerage, and portfolio management. These activities themselves shall not be the focus of this chapter, although they set the stage for the issues to be discussed here: the role of banks in administering stock owners rights in the Boards and the annual shareholders' meetings. The three ways of the banks to assume a role in corporate governance institutions are to hold significant amounts of shares in the corporation, to act as voting agent for small investors in the annual shareholder meetings, or to have a member of the bank hold a seat on the Board directly. In this chapter we shall provide factual information on the extent of bank control over industry by any of the three means, as well as an analysis of the efficiency or drawbacks of this arrangement.

3.1. Equity holdings of German banks

3.1.1. Extent and structure of ownership

"German banks own German industry". For a lot of practitioners as well as academics, this is a statement that does not deserve further reflection. However, in Harm [18] we have already provided statistics showing that actual ownership of real sector firms cannot be too significant, because the AG as the only publicly listable corporate charter accounts for only slightly more than 20% of domestically taxable revenues. Most corporate shares of banks are confined to the AG. Yet, a concern would be whether banks control a major portion of the nation's largest firms, thereby shaping domestic industrial policy not only directly in the large corporations, but also indirectly when the decisions of the large firms trickle down to affect dependent smaller businesses.

The first task in this chapter is then to assess the extent of banks' stock ownership in the largest firms. Appendix 1 shows the distribution of ownership among different groups of owners in the largest 100 firms. The table was compiled from various tables in the Monopolkommission's [34,35] 1979 and 1989 reports. The first report was not aimed at giving a complete account of ownership in the largest firms so that the table has a number of missing ends, but the data improved a lot until the most recent report, providing a general picture of the structure of ownership in Germany's large industry.

Until recently surprisingly few companies are majority owned by small investors - the majority of shares seemed to be in the hands of the larger institutional investors, which individually or collectively held the absolute majority in the respective firms. More importantly, the stock ownership of banks is not as pervasive as it is often perceived, and was reduced furthermore during the last decade.

Moreover, the tables compiled by the Monopolkommission revealed that there is no ownership link between the companies in which the banks had a stake, and the companies where other firms of the group of the largest 100 firms had a stake. Not a single firm in which a bank had a significant stake, hau a significant stake in any other of the largest 100 firms so that the influence of banks in terms of ownership is truly confined to the corporations listed. Immenga [25,p.33] showed that in 1975 there were eight cases where next to the bank there was another bank or another company from the top 100 listed as a major shareholder, reducing the potential power of one single bank as a shareholder. This is even more pronounced today, where no single bank has a majority stake in one of the top 100 firms.

One does have to note, however, that most individual stakes in the listed companies with bank ownership are held by the three largest German banks, showing that there is a concentration of ownership in the hands of th· largest three banks. Instead of the statement that "German banks own German industry", we would suggest here that a more appropriate statement is "the three largest German banks held significant shares in 13 of the largest 100 firms".

Table 1: Number of equity holdings of 10 largest private banks in non-banks

Share size	1976	1986
1. All firms	129	86
10% - 25%	43	41
25% - 50%	67	37
greater 50%	19	8
2. Publicly listed firms	77	51
10% - 25%	17	20
25% - 50%	49	28
greater 50%	11	3

source: Herrhausen [22]

Also when we consider the holdings of equity including the next smaller group of firms, the issue of bank ownership is not as pervasive as is commonly assumed. Table 1 from Herrhausen [22] was compiled by the Federal Association of German Banks in response to the sixth report of the Monopolkommission, and includes the holdings of the ten largest private commercial banks, i.e. excluding sa.ıngs institutions or cooperative banks.

The 10 banks included in the survey also reported their reasons for 18 new acquisitions of shares in the 10 year period. In six of the cases the banks reported that the motivation was simply a portfolio investment. All of these investments were in the range of between 10% and 25%. More important for this section, there were five cases where the reason was given as placement of equity, in four of these cases those were non-listed firms. In another five cases, the reason was given as supporting the equity base of undercapitalized firms in the Mittelstand, and again four of these firms were not listed on any stock exchange.

These eight cases of non-listed firms point at something that can be regarded as a central message that this chapter wants to deliver: banks can do only rather little about the undercapitalization of German industry, as the true bottleneck seems to be the willingness of entrepreneurs and managers to charter as an AG and get listed. In these eight cases, banks were urged to find non-market means to increase the equity base of client firms by either taking the equity on their own books, or by trying to place a non-marketable share. In only one of the eighteen cases did a bank report that an equity stake was acquired to strengthen a loan, suggesting that the firm was in trouble, and the bank wanted to increase its control in the firm.

In short, in the great majority of the (few) cases reported over the 10 year period the motivation for purchasing shares was rooted in either the unattractiveness of becoming a listed stock issuing firm, or simple portfolio considerations, although the latter is an argument that may well hide other intentions, as a stake larger than 10% in a firm is likely to be incompatible with the conventional wisdom of portfolio diversification. Nevertheless, the survey suggests that there is little or no connection between a bank's share purchasing policy and lending activity.[12] In addition, the survey shows that banks did reduce their holdings significantly over the 10 year period, although it is not apparent, whether this was due to political pressure or economic considerations.

3.1.2. Critique and policy response

The equity holdings of German banks have been a matter of continued criticism in the country. Even though the above data suggest that stock ownership is not very extensive, there is a question whether banks should be allowed to hold shares in industry at all. The arguments against the status quo are most often linked to antitrust reasons. The fear is that bank ownership in various competing firms can lead to monopolistic price collusion to the detriment of the consumer. Factually, however, the Gessler commission as well as the monopolies commission have found that bank ownership permitting such behavior is only observed in the brewing industry, and albeit the theoretical possibility of a cartelization of that industry was not actually observed.

Nevertheless, the monopolies commission recommended to limit bank ownership to 5% of the equity capital of a firm, just because of the theoretical possibility of undesirable cartelization, and the fact that one cannot rule out future bank behavior in this direction to stabilize the value of their shares.[13] The Gessler commission issued an analysis with similar

[12]This was also a conclusion drawn by the Gessler commission (see Krümmel [30], p.51).

[13]See Monopolkommission [32,p.296], also Greiffenberg [16,p.90]

conclusions (Krümmel [30,p.52]), but with softer policy recommendations, asking for a limit of only 25% plus one share, granting a bank a minority veto. Possibly in response to this request, the banks have actually cut down most substantially on their holdings of more than 50% (see table 1), which is characteristic of the relationship of German banks with the government. Banks try to prevent limiting legislation by conforming to some extent with the intent of a pending legislation.

Likewise, the Gessler commission found no evidence that stock ownership influences the client to prefer the respective bank to secure large scale loans or underwrite equity issues. The conclusion was rather that the clients where the banks had substantial stakes had sufficient negotiating power to look for the best service value in the market. One banker that was interviewed in the course of this research mentioned that the largest corporations in the country had started already in the 1960s to create a market for short-term funds among themselves, showing for one thing that banks had to improve their services in response to competition from non-banks. Secondly, this behavior of the largest firms would have hardly been possible, had banks had a significant influence over their clients to curtail such behavior in their own favor.

The last major complaint with respect to banks' equity holdings is that their position makes them virtual insiders, for one thing being able to secure insider gains from their stock holdings, and also being able to sell off stock in a firm that they receive negative information about. Nevertheless, the Gessler commission argued that such behavior was highly visible if carried out on a large scale, and would surely ruin the respective bank's reputation in the long run. To the contrary, the Gessler commission found that the experience had shown that banks with significant equity holdings were actually more willing to support an ailing firm.

This last point deserves some further mention. The closer a firm gets into a crisis situation, the more does the bank face an agency problem with respect to management. In this author's previous work [20], it was argued that with more "realistic" assumptions about the economic agents, the solution to an agency problem would include contracts specifying some form of discretionary authority for the principal in some states of nature, meaning that the traditional agency solution of a rule-based contract may be insufficient to overcome the agency problem.

What this means in the present context is that an optimal debt contract does not only specify rules such as covenants, but also authority provisions, which are the residual rights held by an equity investor. One of the means to achieve such a contingent transfer of rights is that the bank demands to hold equity in the first place so that there is a theoretical possibility that an optimal long-term financing arrangement between a firm and its bank involves the combined use of debt as well as equity instruments.[14] This would enable the

[14]One can also make the converse argument that if the law precludes bank holdings of equity, banks are by necessity in a situation that they have to secure timely exit as they do not have the last resort of directly influencing - or dismissing - managements, which may be the only response to an intensified agency conflict. Such reasoning is supported by the empirical evidence

bank to exercise influence especially in times when managements are exposed to counterproductive incentives. Of course, it is empirically virtually not possible to prove that this kind of financing arrangement is optimal in a given real-world situation so that we have to be content at this point to make a case for its theoretical viability.

This view of optimal financial arrangements also answers the criticism that banks are not to hold equity, because depositors are almost by definition risk-averse, and would prefer the banks to hold safer debt contracts rather than riskier equity contracts on its balance sheet. If we view risk as entirely statistical, this is of course true, but in a model with behavioral risk, the presence of equity in combination with debt contracts actually reduces the risk exposure to the respective client and hence serves the needs of the depositors rather than contradict them.

Finally, there is the point of view that the banks' equity holdings serve as hostages to limit the firm's management's ability to make decisions detrimental to the housebank. The exchange of hostages provides a negotiated (market) solution to the problem of specific assets as studied in Transactions Costs Economics.[15] To the bank, the loan contract is a specific asset, as the bank depends on management's decisions. Instead of writing state-contingent contracts, it is a theoretically feasible solution to the bank's problem to "hold managements hostage" by holding equity.

3.2. Acting as voting agents for equity investors

3.2.1. Voting proxies in shareholder meetings of client firms

Even with comparatively modest holdings of equity in a client firm, German banks are in a unique position to influence the outcome of the firms' shareholders meetings by exercising the proxy votes of the shareholders, who have assigned their bank to handle the administration of their shares in one way or another. Immenga [25,p.102] estimates that banks owned only between 5% and 7.5% of the value of all circulating stocks, but that they administered between 50% and 55% of all circulating stock, leaving them with representing around 60% of all circulating stock between 1963 and 1976. This, however, does not mean that banks had the authority to vote for all shareholders who had their shares in an account with the respective bank, as the bank has to request the authority from the shareholder at least every 15 month, and the shareholder is free to ask his bank to vote for his share deviating from the bank's suggestions.[16]

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of the combination of Glass-Steagall and "arms-length-banking" in the United States.

[15]Williamson [47]

[16]Immenga [25] cites estimates from the banking sector, stating that only about 2% or 3% of all shareholders use their right to ask for specific voting behavior so that the rest is up to the banks' discretion.

Although the representation of up to 60% of total stock value in the economy would theoretically allow for the possibility that banks represent a majority in just about every company's share-holder meetings, this is not true in reality, as most of the value of stock is accounted for by the 10 largest firms, 8 of which are majority owned by the general public. Table 2 was compiled by Immenga [25,p.104] for the data of 1975, and replicated from Appendix II for the data of 1988, and shows those firms, in which banks could conceivably wield influence either through direct ownership, or by proxy vote.

Table 2: Possibilities of banks influencing the top 100 firms via ownership or proxy votes

	Rank	1-10	11-25	26-50	51-100	Total
A. Firms controlled by small investors						
Firms with bank ownership >25%	1975	1	0	6	14	21
	1988	1	2	2	4	9
Firms w/o known large investor	1975	3	2	1	0	6
	1988	0	0	0	3	3
Firms, where small investors hold > 50%	1975	5	0	0	2	7
	1988	7	7	6	7	27
B. Firms controlled by large investors						
Firms with large investors holding 50% - 75%	1975	1	3	3	2	9
	1988	1	3	3	15	22
Firms with large investor holding 75% or more	1975	0	10	15	32	57
	1988	1	3	14	21	39

source: Immenga (1975) [25,p.104]; Table 1b (1988)

It becomes clear that banks cannot have voting power in the second set of firms, which outnumber the first set of firms. This means that also the voting proxies do not fundamentally alter the conclusion that banks do not own - or control - German industry. There is, however, an interesting trend observable in Table 2, namely a move towards decentralization. There are less firms with 75% majority investors, less firms with significant bank stakes, less firms with one or a few non-bank investors holding the majority of shares, but more firms with an atomistic ownership structure. Hence, voting proxies are becoming more important for banks these days.

The discussion on proxy voting has left the stage of questioning the wisdom whether there should be or should not be an institution collecting and homogenizing shareholders votes.[17] Such an institution is needed to overcome the externality that leads to what Demsetz [9] calls "rational voter apathy". One can view this structure as an institutionalization of a collective bargaining process between shareholders and managements not unlike the formation of trade unions to represent labor in its negotiations with managements. After all, the increasing wealth of the general public in the modern industrialized society should lead to an atomization of capital owners resembling the (natural) atomization of labor, leaving the providers of both factors of production in a similar negotiation position with managements, which is nothing but a recognition of the managerial society[18] that we live in.

The question is rather whether such a function should be performed by banks, or whether another set of institutions could be envisioned to carry out the same task. Obviously, the banks in a universal banking system are in a natural position to assume this role due to their securities markets dealings as well as the knowledge of their clients. Körber [29] and Herrhausen [22] argued that banks do not feel that they have an innate right to vote for shareholders, but that the present system survives for lack of better alternatives.

To be sure, there is a theoretical alternative emerging in the United States these days, where institutions called proxy solicitors exist that analyze firms for institutional investors and recommend voting options based on this analysis. As soon as the institutional investors represent a critical mass of shares, small shareholders are convinced to join the voting recommendation. The problem with this approach is that the institutional investor has to pay for the services of the analyzing company. Once there is no institutional investor having a sufficient interest in having the analysis done, the same externality prevails that leads to "rational voter apathy".

This is arguably the reason why the described system would fail in Germany. If banks gain any benefits from controlling shareholder majorities, they will gladly issue the service to analyze the respective corporation free of charge, which is what is happening now so that there is no room for a potential entrant in such a market. It would require some form of (potentially controversial) legislation, to introduce the American system of shareholders' vote pooling to the German market. In short, although banks are not the only candidates to administer voting proxies, it would be hard to envision any other set of institutions taking the place of the banks short of excluding banks from the task by law, which is inconceivable given that it is not even established that banks' voting proxies constitute a problem.

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[17] See Körber [29] for an extensive argument for this case.

[18] As discussed by Bearle and Means [3] and Dahrendorf [8].

3.2.2. Voting proxies on bank shareholder meetings

The exercise of proxy votes by banks on their own shareholder meetings seems to contradict any intuition of democratic ideals one might have, and one needs to take a closer look at the mechanisms of control over a bank. It is not quite clear at first sight how such a structure can prevent management infringing shareholder rights. Obviously, what has been said above about proxy votes in general is also true in the case of banks: Shareholders vote on an agenda suggested by the Board, and the voting process itself has more symbolic than democratic value. However, bank managements would have the theoretical opportunity in this setup, to place only "loyalists" on the Board, thereby sidestepping the control process.

It seems that shareholders' Boards are not the most important control institution for a bank, but it is the bank supervisors. However, especially the largest stock banks are rarely - if ever -physically audited by bank supervisors. German bank supervisors rely first of all on the information to be submitted in accordance with the KWG. Even if the bank supervisors do not audit the bank themselves, irregularities can be uncovered in tax audits or by the auditor preparing the annual report. The most important feature of the banking supervision is that it has the power to veto new and throw out old bank managers. Any major irregularities of a banks' management would surely lead to the termination of the manager's assignment.

However, it is not clear whether a modest but unnecessary increase in salaries, fringes, or other administrative expenses benefitting managements with no apparent economic gain to the bank would constitute an irregularity in the sense of the KWG, and in this regard shareholders of the large banks are disenfranchised.

The relationship between banks and their supervisory agencies must be seen as a reputational equilibrium as defined in the literature by Klein and Leffler [28], or Barzel [2]. Instead of a contractual relationship involving constant monitoring and negotiations, a reputational equilibrium enforces compliance of implicit contractual terms via the price mechanism, granting a monopolistic rent stream to the party with the potential to exploit the other. Salaries, fringes, and tax shelters are the carrot, and the sanctioning power of the KWG is the stick enforcing compliance with the objectives of KWG. In times of prosperity, this solution can be superior to any active contract enforcement, but we may be lucky that Post-War Germany has not experienced a major economic and banking crisis.

3.3. The role of bankers on client firms' Boards of Directors

Part of the reason why voting proxies are seen as a solution rather than a problem is that the issues voted on as well as the voting recommendations are defined after continuing and elaborate discussions between the "Aufsichtsrat" (after all the institution supervising and controlling management) and management. In that sense, shareholder meetings are more of a public relations event than anything else, a point noted also by Körber [29].

This effect is especially strong if there is a banker in the Board, possibly even the head of the Board, as then the voting recommendations issued by the bank administering the voting proxies is likely to be identical to the proposals by the Board. Hence, the true power lies not in the banks' equity shares or voting proxies, but most importantly in the banker holding a seat on the Board.

Saying this, we have to remind the reader again about the two salient features distinguishing the American and the German Board structure, namely that every Board member is a true outsider as there are no managers on the Board, and that the Board serves as a negotiating forum for capital and labor according to the "Mitbestimmungsgesetz". This is again important to stress, as for one thing an outside Board limits the Board members' authority to interfere in the day-to-day management process, but strengthens his position to make personnel decisions at the top management level.

At the same time, the inherent conflict of interest between capital and labor asks for a broader consensus among Board members, which lets the conflict of interest between bankers and shareholders or managements seem rather small. This is to argue that the German legislative system does not leave a banker on a Board as an odd phenomenon, but rather a symbol of the general idea of the German Board: a consensus shaping mechanism for the various stakeholders in the firm. Table 3 shows the extent of Board membership by bankers as well as the distribution of the memberships among different groups of banks. The numbers show that Board representation is a much more common means to influence firms than equity holdings or voting proxies, which should not be surprising given that it is also more effective than the other two means.

Given the large number of AG's with bankers on their Boards compared with the number of firms with significant bank equity holdings, it is clear that the majority of AG's have a banker on the Board without the bank owning significant amounts of shares in the respective firms. This tendency is even more pronounced when we consider that bankers hold significant numbers of Board seats in GmbH's and other corporate forms, in which it is more difficult and unlikely that they have an equity stake. This falls also into the theoretical framework of optimal debt contracts with authority provisions and shows that equity ownership is not mandatory to achieve that goal, which supports Herrhausen's [22] claim that the bulk of banks' equity investments is made solely for the purpose of achieving capital gains.

The importance of Board membership by bankers becomes even more apparent when we consider only the 100 largest corporations in Germany. The 1976/77 report of the monopolies commission [33] showed that bankers were represented in 75 of the 84 firms having an Aufsichtsrat.[19] In 31 cases they committed the president of the Board, and out of these 31 cases, 18 cases were accounted for by Deutsche Bank alone. The concentration among the largest firms should not come as a surprise, however, as the costs of monitoring via Board membership can be considered roughly independent of firm size so that a bank would maximize returns from monitoring by selecting the largest firms first.

[19]Companies chartered as KG, OHG, or sole proprietorship are not required to have a Board according to the "Mitbestimmungsgesetz" regardless of their size.

Table 3: Board member distribution among bank groups in 1974

Bank group	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Savings bank	14	4	6	29	23	7	7	66	119
Giro Centers	10	13	16	86	72	14	5	82	170
Large 6 banks	6	91	100	405	320	24	19	71	483
Regional banks	26	61	72	252	202	16	9	55	314
Private bankers	23	49	38	170	137	4	3	14	185
Cooperative banks	8	2	4	19	16	2	4	31	73
Total	94	220	236	986	64[illegible] (7[illegible][20]	67	47	319	1344

Explanation of columns:

(1): # of banks reporting Board members
(2): # of bankers holding the presidency of the Board
(3): # of bankers holding the vice-presidency of the Board
(4): # of bankers reported as Board members
(2) to (4) refer to Boards of AG's
(5): # of firms with bankers on the Board (only AG's)
(6) to (8) are the same as (2) to (4), but for GmbH's
(9): # of bankers holding Board seats including AG's, GmbH's as well as all other legal incorporations[21]

source: Monopolkommission [32,p.256],Immenga [25,p.109]

Regardless of how prevalent the presence of bankers in German Boards is, one may not forget the role of the Board as a negotiating forum between capital and labor. Table 4 shows the membership structure of the Boards of the largest 100 firms. As was the intent of the law, not quite half of the Board members are labor representatives. Moreover, the unions associated with the DGB account for more members than all banks combined, and they would certainly have more overlapping goals than the different banks. Not regarding the issue of Board presidency, one may then treat the issue of the power of the DGB with equal importance to the issue of the power of the banks. Moreover, the table confirms the notion voiced above that in the way German law defined Board structure, the banker is not an "odd man out".

[20]Deviation because of multiple representation

[21]According to the "Mitbestimmungsgesetz" dating May 4th 1976, all AG's, GmbH's, as well as KGaA's with more than 2000 employees have to have an Aufsichtsrat with labor representation.

Table 4: Board composition in the largest 100 firms in 1986

Member's institutions	# of Boards	# of Board members
Private banks	59	114
Other banks	37	51
Employees/Managers from industry	81	368
Politicians/Government employees	24	69
Other representatives of Capital	61	147
Members of trade unions	77	197
Thereof: Unions associated with the DGB	76	181
Other labor representatives	83	520
Total	84	1466

source: Herrhausen [22,p.108]

One may even consider that bankers hold the presidency of the Board more often, because they represent a third group of stakeholders having "capital-like" incentives due to their equity holdings and market making activities in common stock, as well as "labor-like" like incentive owing to the fact that debt as well as labor represent a fixed claim on the firm, in which case they would be an ideal mediator in a German Board. This, however, must remain a speculative issue as labor representatives are the first to attribute banks to the "capitalist" side (see Greiffenberg [16]), and one cannot dismiss the possibility that also the bank as a lender can theoretically make decisions to expropriate labor.

Yet, one banker interviewed in the course of this research stated that he usually defended labor interests during Board negotiations, for example by sponsoring increases in the company's pension fund for its employees. This is definitely not in the immediate interest of the bank, and only supports the role of the Board president to act as a mediator between capital and labor interests. These issues lead directly to the heart of the discussion on the power of the German banks in German industry, namely the possibility of conflicts of interest that could induce the banker to exploit his position of influence in contradiction to the intent of the position.

3.4. Conflicts of interest

In this section we have to address the question more closely, in how far the controversial issues in German banking, namely equity ownership, proxy votes, and Board memberships, interfere with the "proper" incentives and interests of a universal bank, and how a bank with significant influence in any of the three areas can use its power to the detriment of any other group, and there are obviously many: banks are dealing with managements, union representatives, labor leaders from within the respective firms, other banks that compete for market share in any service provided by universal banks, majority shareholders, and small shareholders.

All of these stakeholders and potential stakeholders have among themselves conflicting interests in the decisions concerning the firm, and one would have to ask in the first place, what the proper incentives of a bank are, and what the resulting ideal behavior would be that we would like to see in a bank. From the point of view of a regulator, this ideal of the role of banks in a society would have to established first, before one can go on to analyze, whether the criticized features of German universal banks actually interfere with the hypothetical ideal.

3.4.1. Firms' value maximizing behavior and the conflicts of interest among different groups of stakeholders

Taking the position of a regulator, the hypothetical ideal would be a situation in which externalities are minimized given the presumption that externalities tend to retard economic growth as the economic agents are more concerned with exploiting the externality - thus transferring existing wealth to them from other economic agents - rather than being concerned about creating economic wealth through growth. Externalities principally must be viewed as a source of economic waste, be it labor or capital that is used to exploit the externality.

The problem of externalities is in some sense synonymous to the agency problem, as the decision-making agent has the power and opportunity to expropriate the principal due to their heterogeneous information and interests. As is well known, the theoretical solution to this conflict lies in the less-informed principal providing incentives to the agent to harmonize their interests. Ronald Coase [7] has shown in his seminal paper that in the absence of communication barriers such as asymmetric information, there need not be any externalities, as any such problem could be solved via negotiations of the involved parties which yield a mutually accepted consensus.

Albeit the presence of cultural norms that try to define a certain homogeneity within a society,[22] it would be futile to believe that in today's diverse societies this can be a way to eliminate all conflicts associated with externalities. The most efficient solution to a conflict of interest is primarily the decentralized one: negotiations involving all interested parties. Only if this is not feasible due to massive communication problems - be they asymmetric information or the largeness of numbers of involved parties - do we need to find a more efficient governance structure for decision-making, be it institutions that negotiate for a large clientele of members, or be it laws sanctioning the exploitation of an externality.

[22]This has been tried in the socialist countries with well-known results,where the education system was supposed to condition people to uniformly work towards the goals of the socialist society.

Translating these general insights to the problem of the various interests of the various claimholders against a firm, it is important to note is that in the first step the firm generates economic value, and that only in the second step do the claimholders argue on how to split the gains among each other. The task is then to set the conditions for the firm's management to maximize firm value, and to distribute the gains among the claimants with the least friction.

The above reasoning suggests that the preferred solution would be a negotiated outcome, if that is not prevented by excessive communication problems. For the first goal, maximizing firm value, Myers [36] has shown that in the presence of debt financing, a management acting in the interest of equity owners alone may not undertake a positive NPV project. This underinvestment problem would not be present, were management liable to an established consensus between debt and equity claimants, and not equity investors alone. Similar arguments could be made for the relationship between capital and labor.

We want to suggest with such reasoning that the composition of the German Board consisting of members of various interest groups, mitigates the problem of management not maximizing firm value due to reasons of stakeholder conflicts alone. The conflict between Board and management is partially resolved by defining a true outside Board that management has to report to, and may not be a part of. Likewise, the division of the firm's economic gains between wages, salaries, interest, and dividends is defined in a consensus process involving all parties.

Obviously, there are also reasons against such a broad Board structure, namely the likelihood of negotiations deadlock because of too much heterogeneity of its participants. These are the kinds of transactions costs that would make alternative corporate governance structures preferable, and it is clear from the discussion preceding the passing of the "Mitbestimmungsgesetz"[23] that these were precisely the fears of the representatives of "Capital": time consuming negotiations with labor would now be continued in corporate Boards, leaving no more room for a meaningful supervisory function. The practice in the last 15 years has shown that continued partisan decision-making in the Boards has not dominated the news so that the experiment seemed to have worked according to the original intent.

To propose the German Board system as a solution to the problem of managements not maximizing the value of the firm does, of course, require a big conceptual leap away from the understanding of property rights as is still found in the United States today, where ownership rights belong only to the shareholders, and they are hence the only ones deciding on who may serve on the Board to represent them. Bleicher, Leberl, and Paul [5,p.43] quote Milton Friedman: "In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which

[23]See Der Spiegel [11] with a 1968 cover issue on legislated labor representation on corporate Boards.

generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in laws and those embodied in ethical customs."

BLP comment that the unequivocal subordination of management under the owners rejects any considerations of external interests. One may not forget that also the creation of property rights in a society was a means towards an end in the sense that only property rights could provide sufficient incentives to individuals to participate creatively in the business process, thereby increasing the wealth of the society. This has been proven by contradiction with the recent experiences of the socialist countries. However, it is not a reason, to view property rights as an end in themselves, and if shareholders collectively waive parts of their property rights in an attempt to overcome agency problems[24] with other claimants on the firm, then this is a Pareto-superior solution to the conflict, hence socially desirable.

The point made in this section was that the structure of the German Board as a negotiating forum among different claimholders ultimately serves the purpose to maximize firm value. Next, we have to analyze how bankers fit into this structure.

3.4.2. The conflict of interest within a universal bank

Subsequently, we are going to argue that a universal banking system averts the problem of a factionalization of stakeholder interests. The banker in Germany issues loans to his clients, underwrites their equity in financial markets, and markets these claims to the general public. Hence, there are three profit centers within the bank that could potentially benefit from any influence of the bank, be it via proxy votes and equity holdings or Board seats. Not considering the problem that shareholders within themselves are a highly heterogeneous groups, making it difficult for that part of the bank that deals in equities to adequately represent their clientele in order to take market share away from competitors, there is a fundamental conflict of interest between the lending side of the bank and the equity-dealing side of the bank.

Once a bank would induce management to act overly conservative in order to secure the repayment of the loans, the bank would act against its interest to maximize share value and attract retail business in the equity markets. The same conflict occurs, when it comes to the dividend decision. One banker interviewed in the course of this project that had held Board seats including Board presidencies in his career stressed that he had usually argued to increase the dividend, reflecting that he had taken the side of the shareholders in their negotiations with management, which would instead prefer to have profits allocated to retained earnings.

[24]It must be noted again here that due to the assumption of bounded rationality in transactions cost economics, the solution to an agency conflict may involve the transfer of authority, as for example the partial transfer of property rights. This solution could not be found in an agency model with the traditional assumptions of "economic man".

This was supported in discussions with other bankers who stated that the fee earning business of securities dealings was more lucrative than the interest business in loans, and it supports again the conclusion drawn by the monopolies commission that banks "intimate" relations with industry were rather independent of their lending business.

Likewise, the monopolies commission had not found significant links between banks' power and their ability to influence firms' decisions when it came to selecting an agent to underwrite equity issues, as they argued that the few firms that frequently went to the market to finance their ventures had enough negotiating power to override any non-competitive interests of the bank. Bannock [1,p.230] actually made the reverse point, which was also confirmed by a manager of a large company interviewed here: "A house-bank that did not show solidarity with management (by advising its clients to buy shares in its company and advising them to vote their shares with management on shareholders meetings) would soon cease to be the company's house-bank."

This, of course, turns the whole discussion on the power of the banks upside down, and makes this more of an issue of the lack of power of the banks, because they are in a vulnerable position due to their business interests. This seemed to be the only critique of the system where bankers hold proxy votes and seats on the Boards that was not rejected by any evidence available. One may not forget, however, that the president of the Board has - in case it is called for - the decisive vote whether to dismiss management or not so that there is ultimately a healthy balance of power.

The first conclusion in this section should be that there is no apparent evidence for the abuse of power of the banks when it comes to either securing business away on a grand scale from competing banks, nor neglecting the interests of small equity investors in favor of the banks loan portfolio. The only problematic issue may be that banks are not strong enough to represent shareholders in their negotiations with management.

Moreover, the banker himself has so many competing interests that it is unlikely that he chooses one in favor of another one. This brings us back to the basic question that we started out with: What are the appropriate incentives of a banker? Especially when the bank holds both an equity stake[25] as well as loans in the firm, it becomes clear that the banks incentives resemble more those of an owner-manager in an unleveraged firm (with the exception of the incentives versus other debt holders), which counters the negative consequences of a factionalization of stakeholder interests, and it may be precisely this feature of a universal banker that makes him a prominent candidate for a Board position.

In the course of the consensus-shaping process between the various stakeholders of a firm, the Board structure as defined by German law is supposed to minimize the impact of stakeholder conflicts on firm policy. The banker is a likely candidate of a Board president, because his incentives are closest to the incentives of the firm viewed as a whole. He is the

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[25]The same effect is achieved through the bank's involvement in equity markets, as they are also representing equity interests to attract retail investors.

person most likely to support the process of reaching a consensus, which is vital for the efficiency of the Board given that capital and labor representatives have such heterogeneous interests.

It must be stressed again that the conclusion to support Board membership of bankers is not universally true, but is rooted in three important features of the German system: that the Board is a true outside Board, that its composition is very heterogeneous, and that the banker in a universal banks shares the incentives of debt and equity alike, and is hence most interested in the growth of the asset side of the balance sheet, rather than redistribution on the liability side.

3.5. From collateral to creditworthiness lending

We have argued above that because of the possible authority granted to bankers through equity shares, proxy votes, and Board seats, banks would be more willing to lend long-term as opposed to those banks that do not enjoy these privileges. We want to argue for another advantage that comes with this structure.

While the academic literature has essentially decided to talk mostly about loan valuations in terms of the probability of repayment, the real world of banking in Germany seems to be far from the ideal of creditworthiness lending. Gessner et. al. [15] showed in a study on bankruptcies that banks were on average able to secure 85% of the amount of loans in default through their collateral.

A banker interviewed in the course of this research stated that the presence of a representative of the bank on the respective company's Board made it more likely that the company received unsecured funds, which then obviously reduced the liquidity constraints of the company because of the informational advantage the bank gains with the Board seat. Unfortunately, there are no data available to support this claim, but Hoshi, Kashyap, and Sharfstein [23] found similar evidence in the Japanese market, making this argument also plausible for the German banks.

The important thing to realize when discussing the issue of the power of German banks is that they may actually be seeking influence for the sole purpose of expanding their business. Similar to the credit guarantee agencies, which provide the banks with security in the absence of collateral, the influence of banks in large firms, which are not eligible for government support for obvious reasons, may serve as a substitute for collateral.

In the absence of governance structures that ensure a continued relationship of trust between borrower and lender, financial claims cannot - by virtue of the nature of the product - be traded in a highly competitive spot market. Banks' seats on Boards or their voting proxies may simply support a relationship of trust when no material security is available. In the language of Williamson [47] firms would provide hostages to support the exchange of funds - the same rationale as applied to equity holdings above. These arguments go hand in hand with the statements made by bankers in the interviews that there is comparatively little no price discrimination between loans contingent on the risk of the borrower. Financial markets function only to a small extent via the price mechanism. Riskier borrowers are rationed out of the market. In that sense, the abolition of banks' source of power would predictably lead to less liquidity in industry.

3.6. The hor ebank as an equity underwriter and the question of under-capitalization of German industry

Discussants of the German financial system never fail to stress the low equity endowment of German industry. Likewise, the report issued by the Verband der Vereine Creditreform [43] singled out low equity capital as one of the most commonly stated reasons for bankruptcy. As the banks are responsible for placing the claims on the capital markets, they are often subjected to the blame for "retarded" equity markets. We cannot follow this point of view here.

First of all, a true comparison of equity ratios across nations would require a comparison of the possibilities under the respective nation's tax laws to build hidden reserves. Especially with respect to real estate valuation, but also to some extent with respect to building precautionary reserves, German firms seem to enjoy some discretion to add to hidden reserves.[26]

More important in this context, we know that there are only about 2000 firms chartered as AG, and these are the only firms that banks help with their capitalization. Moreover, banks seem to enjoy higher profits in the equity business than in the loan business so that they actually have every incentive to convince a client firm to go public. The limiting factor is not the banking system, but it is the legal definition of the AG as a corporate charter, with disclosure requirements and labour representation on the Board as strong disincentives to go public.

We have shown in Harm [18] that German industry is made up to a large extent of smaller firms that are not publicly traded. The industry is still separated into two distinct groups: the few large AG's, which are subjected to one of the world's most rigorous standards of corporate democracy, and the bulk of all other firms, which live under rather old-fashioned "capitalist" corporate governance structures. At least when it comes to the smaller firms in the "Mittelstand", one may well argue whether it needs legal standards to enforce corporate democracy in an environment where the numbers of involved people is small enough to allow for individual negotiations. In any event, the conclusion here must be that despite the German banks' involvement in equity markets, the true reasons for the

[26]This can also counter the criticism by Steinherr and Huveneers [42] that the large extent of financing via retained earnings show the weakness of the German banks to finance industry appropriately. Hidden reserves are built with tax shelters, making the self-financing a result of tax legislation. According to the pecking order theory of finance, internal financing is always preferred to external financing, and the support of the former via tax shelters makes self-financing the choice of an entrepreneur, not the failure of banks.

undercapitalization of German industry - if it is truly a problem - must be searched for in the legislative system that defines corporate charters.

4. Summary and final analysis

Authority has been a part of societies since the beginning of the formation of social groups, and it has been a pervasive issue ever since. The problem with the concept is that authority is redundant if it does not face dissent, but that it is challenged with abuse of power from those that have a dissenting opinion. In that spirit, the issue of the power of German banks is not an issue about banks, but an issue about the concepts of power and authority. Authority is especially sinister to the economist, who has been trained to study decentralized markets, and authority carries the bad taste of socialist planned economies. Only recently has the economic profession discovered the efficiency properties of authority, analyzed in detail by Williamson's [46] theories on Transactions Cost Economics. We have selectively made a case above that such reasoning - applied to the nature of financial claims - may well lead to efficient debt contracts with authority provisions materializing in Board seats, proxy votes, or equity ownership.

While it is true that these issues defining the power of the banks may have their roots only in the history of the German banking system, and may have outlived their cause in today's world, we mean to have shown above that these institutions have maintained their existence due to external factors, most notably the legislation defining Board composition and bankruptcy legislation. It is still possible to make a case for the efficiency properties of the mode of financing of large industry in Germany in the given legislative environment, although the hypothesis is empirically untestable. In the absence of empirical tests determining the optimal mode of financing, a critique of the present mode of financing large industry in Germany has to focus on the abuses verified in the present system. When it comes to anticompetitive pressures exerted by banks, be it in the banking system itself or in industry, banks have been vindicated by all major studies examining the banking system[27]. The same holds true for the issue of conflicts of interest between the major stakeholders in the corporation, and we have suggested above that the present structure of corporate governance may well be the one in which managers are provided with the correct incentives to maximize firm value.

The recommendations of the monopolies commission [34] to limit bank ownership of non-bank firms to between 5% and 10% of the enterprise, and the softer recommendation of the Gessler commission to limit bank ownership to a blocking minority (25% plus one share), are all based on the **potential** for abuse, but not on actually verified abuse. We can go back to what was said above: the potential for abuse is a phenomenon that is by definition linked to the concept of authority so that limiting legislation does not necessarily address the particular features of the financing of large industry, but is rather an expression of man's innate fear of the abuse of power by an authoritative position.

Legislation according to the recommendations has not been passed in Germany, and we portray the view here that this was the correct policy response, as the mere potential for

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[27]Monopolkommission [32,34], Gessler Commission (Krümmel [30]), Economists Advisory Group [17], Büschgen [6]

abuse of power cannot be a trigger for legislative action, but only verified abuse due to a tilted balance of power, which has not been detected in Germany. It would therefore also be a major mistake to follow the recommendations of Steinherr and Huveneers [42] to pass banking legislation for the European Community to that respect, as also they have nothing else to offer but the potential for abuse.

The success of the German banking system will be decided in the European marketplace, and it is may well be that German banks will act very differently in another European country with a different legal and cultural environment. To deny the German banking system a test in the marketplace on the basis of hypothetical problems would be a potential limitation of the efficiency of the emerging European financial marketplace.

It is often challenged that the undercapitalization of industry is displaying a major weak point in the financial system. We have been arguing above that the large extent of self-financing may well have its roots in the tax laws allowing the build-up of hidden reserves. These hidden reserves should first of all be counted towards equity, which could arguably improve the standing of German industry in international statistics on capitalization. Moreover, the build-up of hidden reserves and the accompanying financing via depreciation is a matter of natural choice according to the pecking order theory of finance, and does not necessarily imply a weakness of the financial institutions.

Likewise, the small size of German equity markets is not a consequence of German banks preferring to issue loans to their clients. According to the bankers that were interviewed, the profit motive leads them to argue for firms going public. The binding constraint is the legal definition of the AG as a corporate charter, limiting the demand of entrepreneurs to go public. We may see significant changes when the European Community decides to define corporate charters that can be adopted throughout Europe.

In this author's opinion, one of the most important reasons for the success of the large industry in Germany are the rigorous standards of corporate democracy as laid out in the legal definition of Board structure. The quality of financial intermediation rises and falls with the quality of a governance structure representing the interests of investors and creditors alike. The inclusion of labor in the consensus process has led to rather peaceful Capital-Labor relations in Germany, reducing the agency costs of repeated strikes.

Similar costs arising from the conflict between debt and equity are reduced by the role of banks in the financing process. The present Board structure reduces the negotiation costs between the various stakeholders in the firms by strengthening the decentralized consensus shaping process, ultimately providing the best incentives for managements to maximize firm value unimpeded by stakeholder conflicts.

Although we are aware of the political obstacles in a number of countries today to pass legislation towards corporate democracy, the beginning step is to define a Board as a forum of true outsiders with largely control responsibilities, curtailing the Board's authority with regard to ongoing managerial decisions. This structure was legislated in Germany already in the 1870s, and such a Board structure leads to a natural evolution towards a negotiating forum for all stakeholders, ultimately also explaining the role of German banks in the corporate governance institutions today.

Table 1a: 1978 Ownership of the largest 100 firms

		Owners						
Name	Rank 1972	Public Sector	Banks & Insurance	100 biggest Companies	Individuals & Families	Foreign Owners	Other Investors	Small Investors
Volkswagenwerk AG	1	20,00%						60,00%
Siemens AG	2							80,00%
Daimler-Benz AG	3		~50%	10,00%		14,00%		
Thyssen AG	4				~25%			65,00%
VEBA AG	5	44,00%						56,00%
BASF AG	6							>80%
AEG-Telefunken	7							>50%
Hoechst AG	8							>80%
Ruhrkohle AG	9			27,20%		13,02%		
Bayer AG	10							>80%
RWE AG	11	>50%						
Friedrich Krupp GmbH	13				74,99%	25,01%		
ESSO AG	14							
Gutehoffnungshuette Aktienverein	15		30,00%		~20%			
Flick Industrieverwaltung KGaA	17				100,00%			
Deutsche Shell AG	18							
Mannesmann AG	19							>80%
Bosch GmbH	22							
Metallgesellschaft AG	23		>50%	>25%		16,46%		
Reemtsma Cigarettenfabriken GmbH	24				65,00%			
Gelsenberg AG	26			96,10%				
Salzgitter AG	28	100,00%						
Karstadt AG	30		>50%					
ARAL AG	31			~84%				
Deutsche BP AG	32							
Kaufhof AG	33		>50%					
Gustav Schickedanz KG	40				100,00%			
Oetker-Gruppe	41				100,00%			
Henkel KGaA	43				100,00%			
Kloeckner Humboldt Deutz AG	44			<50%				>50%
Deutsche Lufthansa AG	45	>75%						
C&A Brenninkmeyer	47				100,00%			
Bayrische Motorenwerke AG	49				~70%			
CO OP Zentrale AG	50					22,40%	77,60%	
Standard Elektrik Lorenz AG	51					85,93%		
Philipp Holzmann AG	52		>50%					
Mobil Oil AG	53							
Hochtief AG	54		>25%	33,89%				
BayWa AG	55		>25%					
Saarbergwerke AG	56	100,00%						
Degussa	57		>25%	>12%				>50%
Kloeckner-Werke AG	58					>25%		>50%
Preussag AG	59		40,00%					~60%
Neckermann Versand AG	61			51,20%				
Horten AG	62		25,00%			>25%		
Deutsche Babcock Ag	65		>5%			25,02%		~70%
VEW AG	66	52,56%	>15%	7,59%				
Vereinigte Industrieunternehmen AG	67	100,00%						
Bosch-Siemens Hausgeraete GmbH	68			50,00%				
Otto Wolff AG	69				<75%			
Dyckerhoff & Widmann AG	72		16,00%	13,00%	~30%			
Stahlwerke Roechling-Burbach GmbH	73				2,10%	97,90%		
Ruhrgas AG	74			51,50%			34,80%	
Continental Gummi-Werke AG	75		<25%	11,59%				>60%
Strabag Bau-AG	76			>25%				>50%
Chemische Werke Huels AG	77			100,00%				
Stahlwerke Suedwestfalen AG	78			98,90%				
Grundig AG	79					>12%		
Hapag-LLoyd AG	80		>75%					

source: Monopolkommission [34]

Table 1a: 1978 Ownership of the largest 100 firms

		Owners						
Name	Rank 1972	Public Sector	Banks & Insurance	100 biggest Companies	Individuals & Families	Foreign Owners	Other Investors	Small Investors
Agfa Gevaert AG	81			50,00%		50,00%		
Messerschmidt-Boelkow-Blohm GmbH	82	28,05%		22,02%	4,89%	12,75%		
Otto Versand	83				50,00%	15,00%		
Stumm GmbH - Mebanaft Gruppe	84				>50%			
Axel Springer Verlag AG	86				100,00%			
Schering AG	87							>50%
AG der Dillinger Huettenwerke	92			>25%		>50%		
Wilhelm Werhahn	94				100,00%			
Getreide-Import GmbH	96		100,00%					
Linde AG	100							~90%
Bertelsmann AG	67*				89,30%			
Bilfinger + Berger Bau-AG	73*		<50%					>50%
Franz Haniel & Cie. GmbH	76*				99,00%			
Bayernwerk AG	77*	60,00%		40,00%				
Tengelmann Warenhandelsgesellschaft	79*				100,00%			
Elf Mineraloel GmbH	80*					2,83%		
Magirus-Deutz AG	83*			98,00%				
E. Kampffmeyer	88*				100,00%			
Zahnradfabrik Friedrichshafen	89*				*	4,00%		
Touristik Union International GmbH KG	95*	12,37%						
Rheinische Olefinwerke GmbH	99*			100,00%				
* 1978 ranking, as no 1972 ranking available								

source: Monopolkommission [34]

Table 1b: 1988 Ownership of the largest 100 firms

Name	Rank 1972	Rank 1988	Owners 100 biggest Companies	Banks & Insurance	Foreign Owners	Public Sector	Individuals & Families	Small Investors	Other Investors
Daimler-Benz AG	3	1	2,00%	34,90%	14,00%			44,60%	4,50%
Siemens AG	2	2					10,00%	90,00%	
Volkswagenwerk AG	1	3				17,60%		82,40%	
BASF AG	6	4						100,00%	
Bayer AG	10	5						100,00%	
Bosch GmbH	22	6					100,00%		
Hoechst AG	8	7			>24%			<76%	
Ruhrkohle AG	9	8	90,50%						9,50%
VEBA AG	5	9						100,00%	
Thyssen AG	4	10		9,90%			25,60%	64,50%	
RWE AG	11	11	2,10%		30,60%			67,30%	
Deutsche Bank AG	/	12						100,00%	
Mannesmann AG	19	13						100,00%	
Bayrische Motorenwerke AG	49	14	0,80%	5,00%			50,01%	44,19%	
Ford-Werke AG	/	15			99,80%				0,20%
Deutsche Lufthansa AG	45	16		5,00%		71,45%		23,55%	
Adam Opel AG	/	17			100,00%				
IBM Deutschland GmbH	/	18			100,00%				
Dresdner Bank AG	/	19						100,00%	
Friedrich Krupp GmbH	13	20			25,01%		74,99%		
MAN AG	/	21		21,20%				78,80%	
Allianz Holding AG	/	22						75,00%	25,00%
Messerschmidt-Boelkow-Blohm GmbH	82	23	13,7%*	14,60%	10,70%	52,30%	8,70%		
Commerzbank AG	/	24						100,00%	
Karstadt AG	30	25		>50%				<50%	
Salzgitter AG	28	26				100,00%			
Hoesch AG	/	27						100,00%	
Allg. Deutsche Philips Industrie GmbH	/	28			100,00%				
Asea Brown Boveri AG	/	29			76,00%			24,00%	
Feldmühle Nobel AG	/	30						100,00%	
REWE Handelsges. Leibbrand oHG	/	31					50,00%		50,00%
Deutsche Unilever GmbH	/	32			100,00%				
Zahnradfabrik Friedrichshafen	/	33					100,00%		
Standard Elektrik Lorenz AG	51	34			85,90%			14,10%	
Kaufhof AG	33	35						<50%	>50%
Gustav Schickedanz KG	40	36					100,00%		
Bayerische Vereinsbank AG	/	37						86,00%	14,00%
Degussa	57	38	17,00%	12,50%				63,00%	7,50%
Saarbergwerke AG	56	39				100,00%			
VEW AG	66	40	13,40%	>15,9%		>50%		<20,7%	
Bayer. Hypo.- und Wechselbank AG	/	41		24,20%				75,80%	
Metallgesellschaft AG	23	42	8,68%	42,50%	35,00%			13,82%	
ITT Ges. für Beteiligungen mbH	/	43			100,00%				
Carl-Zeiss-Stiftung	/	44							100,00%
Bertelsmann AG	/	45					100,00%		
Preussag AG	59	46		48,80%			5,00%	46,20%	
Henkel KGaA	43	47					70,00%	21,50%	8,50%
Nixdorf Computer AG	/	48					50,00%	50,00%	
BATIG Ges. für Beteiligungen mbH	/	49			100,00%				
Continental Gummi-Werke AG	75	50						100,00%	
FAG Kugelfischer Georg Schäfer KGaA	/	51					51,50%	48,50%	
Hamburger Ges. für Beteil. Verw. mbH	/	52				100,00%			
Vereinigte Industrieunternehmen AG	67	53						100,00%	
Bayernwerk AG	/	54	38,84%			61,16%			
Ruhrgas AG	74	55	36,31%						63,69%
Deutsche Babcock Ag	65	56						100,00%	
Linde AG	100	57		32,00%				68,00%	
Kloeckner-Werke AG	58	58		19,60%			>40%	<40,4%	
Schering AG	87	59						100,00%	

source: Monopolkommission [35]

Table 1b: 1988 Ownership of the largest 100 firms

Name	Rank 1972	Rank 1988	Owners: 100 biggest Companies	Banks & Insurance	Foreign Owners	Public Sector	Individuals & Families	Small Investors	Other Investors
Hertie Waren- und Kaufhaus GmbH	/	60					100,00%		
Westdeutsche Landesbank Girozentrale	/	61				66,60%			33,40%
Enka AG	/	62			97,20%			2,80%	
Compagnie de Saint-Gobain	/	63			100,00%				
Saarstahl Völklingen GmbH	/	64			24,00%	76,00%			
C&A Brenninkmeyer	47	65					100,00%		
Asko Deutsche Kaufhaus AG	/	66						55,00%	45,00%
Hochtief AG	54	67	44,00%	16,90%				<37,2%	>1,9%
Axel Springer Verlag AG	86	68					50,10%	39,90%	10,00%
Bosch-Siemens Hausgeraete GmbH	68	69	100,00%						
Rheinmetall Berlin AG	/	70					32,00%	33,30%	34,70%
Kloeckner Humboldt Deutz AG	44	71		<51,48%			>24,88	<23,64%	
Nestlé Deutschland AG	/	72			97,60%			2,40%	
Wacker-Chemie GmbH	/	73	50,00%				50,00%		
Freudenberg & Co.	/	74					100,00%		
Philipp Holzmann AG	52	75	20,00%	40,43%				39,57%	
Berliner Kraft- und Licht AG	/	76	20,00%			50,80%		29,20%	
Volksfürsorge Dt. Lebensvers. AG	/	77	30,01%		25,01%				44,98%
DG Bank Dt. Genossenschaftsbank	/	78				0,50%			99,50%
C.H. Boehringer Sohn, Ingelheim	/	79					100,00%		
Otto Versand	83	80					65,00%		35,00%
Bank für Gemeinwirtschaft AG	/	81	50,01%		0,50%				49,49%
Victoria Lebensversicherungs AG	/	82						100,00%	
Flughafen Frankfurt Main AG	/	83				100,00%			
Diehl GmbH & Co.	/	84					100,00%		
Eschweiler Bergwerksverein AG	/	85			96,50%			3,50%	
Boehringer Mannheim GmbH	/	86					100,00%		
Michelin Reifenwerke KGaA	/	87			100,00%				
Grundig AG	79	88	7,10%		24,50%		68,40%		
Beiersdorf AG	/	89		31,20%			>25%	~20%	
PWA Papierwerke Waldhof-Asch. AG	/	90		25,00%		10,00%		65,00%	
E. Merck	/	91					100,00%		
Bergmann Elektricitätswerke AG	/	92	37%**	61,9%**				1,10%	
Miele & Cie. GmbH & Co.	/	93					100,00%		
Bayerische Landesbank Girozentrale	/	94				50,00%			50,00%
SKF GmbH	/	95			99,90%				0,10%
Alusuisse Deutschland GmbH	/	96			100,00%				
Strabag Bau-AG	76	97					>25%	<75%	
VDO Adolf Schindling AG	/	98					73,70%	26,30%	
Energie-Versorgung Schwaben AG	/	99				100,00%			
Aachener und Münchner Beteil. AG	/	100			[illegible]0,00%			80,00%	

* Majority stake in Messerschmidt-Boelkow-Blohm GmbH sold to Daimler-Benz AG in 1989

** Bergmann shares sold completely (98,9%) to non-bank as of 1/1/89

source Monopolkommission [35]

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